MANAGED FUNDS ASSOCIATION

TESTIMONY

OF

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PRESIDENT
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BEFORE THE

SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND
RISK MANAGEMENT

OF THE

HOUSE COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES

FOR A HEARING ENTITLED:
"REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION"
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Testimony of John G. Gaine, President, Managed Funds Association
Before the General Farm Commodities and Risk Management Subcommittee
of the House Committee on Agriculture
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Mr. Chairman and Members of this Subcommittee, my name is John G. Gaine and I am the President of Managed Funds Association ("MFA"). MFA appreciates the opportunity to provide testimony for the Subcommittee's consideration in connection with the reauthorization of the Commodity Futures Trading Commission (the "Commission" or the "CFTC").

We commend the Subcommittee for this timely hearing and for its leadership during the last reauthorization process, which ultimately led to the adoption of the Commodity Futures Modernization Act of 2000 ("CFMA"), a law we believe has served our industry and the U.S. capital markets extremely well. The CFTC equally deserves significant credit for a steady, sensible hand in implementing the CFMA for the past four years. Because of the many positive aspects of this law, as I will explain in my testimony, MFA is not advocating any statutory change at this time. If Congress does decide to change the existing law, we believe it should do so carefully while preserving the ideals of the CFMA.

About MFA

MFA is the primary trade association representing professionals who specialize in the management of alternative investments, including hedge funds, funds of funds and managed futures funds. MFA has over 850 members, including representatives of 35 of the 50 largest hedge fund groups in the world. Our members, many of whom represent firms that are registered with the CFTC as commodity trading advisors ("CTAs") and commodity pool operators ("CPOs"), manage a substantial portion of the over $1 trillion invested in alternative investment products globally.

MFA has been a vocal advocate for sound and sensible public policy in this important sector of the financial world—a sector that provides many benefits to the global marketplace. Our members offer investors the ability to diversify their portfolios in a meaningful way by providing investment products that perform in a manner that is not correlated to the performance of more traditional stock and bond investments. These alternative investment vehicles provide liquidity to the futures and other markets, which serves to increase the efficiency of the price discovery and hedging functions of these markets.

As major customers of futures exchanges, futures commission merchants as well as other futures industry services, many of MFA's members directly benefit from the provisions of the Commodity Exchange Act (the "CEA") and, in particular, the modernizations brought about by the CFMA. The Commission's oversight of the functioning of and participation in futures markets has an important impact on CPOs, CTAs and their clients. Furthermore, many aspects of MFA members' business

operations (such as sales, promotional, registration and operational activities) are also subject to regulation by the National Futures Association ("NFA") —the industry's self-regulatory organization. The Commission and the NFA oversee the business activities of CPOs and CTAs through registration, disclosure, anti-fraud, recordkeeping and reporting requirements. Each of the futures exchanges also monitors the trading activities of our members in their respective markets.

Many of MFA's members are subject to regulation under other federal legislation in addition to the CEA. The public offer and sale of interests in commodity funds are subject to the Securities Act of 1933 (the "1933 Act"), which requires registration of these interests and mandates certain disclosure obligations. Commodity funds are also subject to the Securities and Exchange Act of 1934, which requires the filing of certain publicly-available reports and finally to the individual securities laws of each of the 50 states. Moreover, under the Investment Advisers Act of 1940 ("Advisers Act"), most hedge fund managers will soon be required to register with the Securities and Exchange Commission ("SEC") as investment advisers. MFA's members also will be subject to the anti-money laundering requirements of the USA PATRIOT Act of 2001.

Since the last reauthorization in 2000, and as I testified before this Subcommittee in June 2003, MFA has worked together with the CFTC on a number of important rulemaking projects. We believe the CFTC's efforts at reducing unnecessarily burdensome regulations, also a direct result of the CFMA, will continue to encourage greater use of futures products in the financial marketplace. Accordingly, we are delighted to be here today to discuss the importance of the CFTC and the statutory framework under which it operates to our industry.

MFA's Response to Industry Developments

MFA has undertaken a number of private sector initiatives to promote the integrity, safety and soundness of alternative investments. Some Subcommittee Members may recall that in 1998, after the near-collapse of Long Term Capital Management, both the public and private sectors focused upon ways to reduce systemic risk in alternative investment vehicles. In 1999, one notable public sector response was the report published by the President's Working Group on Financial Markets entitled, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (the "PWG Report"). The PWG Report recommended a number of measures, both public and private, designed to enhance market discipline in constraining excess leverage. Specifically, the PWG Report recommended that hedge funds establish a set of sound practices for their risk management and internal controls. In February 2000, "Sound Practices for Hedge Fund Managers" ("Sound Practices") was published as an industry response to this recommendation.

MFA believes that the public and private sector measures implemented in the aftermath of LTCM, such as those described in the "Sound Practices," have successfully reduced the exposure of global financial markets to systemic risk. As a testament to this belief, MFA updated these "Sound Practices" in 2003 and is in the process of drafting another substantial update of this document for 2005. Similarly, in the anti-money

laundering context, before it was clear that hedge funds would be subject to the PATRIOT Act, MFA published its "Preliminary Guidance for Hedge Funds and Hedge Fund Mangers on Developing Anti-Money Laundering Programs" ("Preliminary Guidance") in early 2002. Both the "Sound Practices" updates as well as the "Preliminary Guidance" are clear examples of MFA's work to respond to the goals of Congress and regulatory agencies of promoting the integrity of financial markets and their participants.

Benefits of the Alternative Investment Industry

Increased interest in and use of alternative investments is a direct result of the growing demand from institutional and other sophisticated investors for investment vehicles that deliver true diversification and help them meet their future funding obligations and other investment objectives. Our members' funds perform a number of important roles in the global marketplace, including contributing to a decrease in overall market volatility, acting as "shock absorbers" and liquidity providers by standing ready to take positions in volatile markets when other investors choose to remain on the sidelines. Fund activity also provides markets with price information, which translates into pricing efficiencies, and assists in identifying pricing inefficiencies or trouble spots in current markets. Moreover, these funds utilize state-of-the-art trading and risk management techniques that foster financial innovation and risk sophistication among market participants

Hedge Funds Effect on Energy Markets

Energy markets enjoy all of these described benefits provided by the alternative investment industry. However, there has been increasing discussion about hedge funds and their effect on the energy markets, including recently expressed interest from Members of Congress. Some market participants have argued that price swings and volatility in these markets are a result of the impact of speculative futures trading by hedge funds. Recently questioned on this topic, both the CFTC and the Federal Energy Regulatory Commission ("FERC") generally concluded that the fundamentals of free market behavior as opposed to trading activity by hedge funds drive the prices of natural gas futures. The CFTC stated "it does not believe that hedge funds are the major source of price volatility in the natural gas market."

We believe the CFTC is doing an excellent job in overseeing the energy trading market. As Acting Chairman of the CFTC Brown-Hruska recently noted, the CFTC staff is routinely in contact with staff at FERC to exchange information about natural gas futures and cash market activity. Any unusual market developments or potential concerns about contracts traded on the futures exchanges, including natural gas contracts, are reported at regular weekly surveillance briefings at the CFTC. Additionally, CFTC economists monitor prices and price relationships in and between the futures and cash markets for natural gas, with the objective of determining if there are price distortions and evidence of manipulation. Furthermore, given the unprecedented level of CFTC enforcement actions in the energy markets over the past two years, which includes assessments of approximately $300,000,000 in penalties, we believe the agency has

shown just how prudent and aggressive it can be when it comes to pursuing wrongdoing in the marketplace. The industry, including MFA members who trade in these markets, benefit from appropriate regulatory actions since these actions promote fair and efficient pricing in the marketplace.

MFA is comfortable that this issue has been, and continues to be, appropriately monitored and that the CFTC, FERC and New York Mercantile Exchange each have correctly recognized that hedge funds are not dominating energy trading and are not the cause of price swings in the energy market. Rather, as previously discussed, hedge funds have the positive effect of increasing available liquidity and decreasing overall market volatility.

Avoidance of Duplicative Regulation

The Congressional intent of the CFMA is to avoid instances of unnecessary overlapping regulation between federal agencies and the consequent duplicative compliance costs. Our concern focuses on those hedge fund advisors registered with the CFTC as CTAs and CPOs that will now be required to also register with the SEC as investment advisers. A potential means of stemming duplicative federal agency oversight would be to define the word "primarily" as it is used in Section 203(b)(6) of the Advisers Act and in Section 4m(3) of the CEA. Under the Advisers Act, a CTA registered with the CFTC is excluded from the requirement to register with the SEC if his or her business "does not consist *primarily* of acting as an investment adviser." A parallel exclusion from the requirement to register with the CFTC exists under the CEA for investment advisers that are registered with the SEC and "whose business does not consist *primarily* of acting as a CTA." We believe the SEC and the CFTC should undertake to define the criteria a CTA or registered investment adviser must meet to exempt them from dual registration. Our members would greatly benefit from interpretive relief or guidance in this area. We ask this Subcommittee, through your oversight authority, to encourage these two federal agencies to work together on this and other duplicative provisions so that compliance obligations are not redundant or overly burdensome. MFA is available to provide any assistance in this matter that is helpful to the process.

Importance of the CFMA

I testified on behalf of MFA before this Subcommittee in support of the bill that became the CFMA, and we continue to be a strong supporter of the law. Its passage in December 2000 represented a landmark legislative accomplishment that set the groundwork for the regulatory structure governing today's futures industry and led to unprecedented industry growth. The alternative investment industry also has seen significant growth over the past four plus years, due in no small part to the passage of the CFMA.

One of the central themes of the last reauthorization was the deregulation of exchanges, which has led to increased competition on a product-by-product basis. These changes have yielded dramatic benefits to investors, which we believe should continue to be the focus of the Commission reauthorization process and all future regulation and

legislation initiatives in the alternative investment industry. The CFMA provided the foundation for the advancements we have seen in the futures industry over the past few years, as I will discuss below.

CFTC Registration Exemptions

During 2002-2003, the Commission modernized the following key rules that have significantly impacted MFA members who are CPOs and CTAs:

Rule 4.13(a)(4): This rule, proposed by MFA, provides an exemption from registration with the Commission for CPOs that operate hedge funds limited to individuals that are "qualified eligible persons" under CFTC Rule 4.7 (generally with an investment portfolio of at least $5 million) or limited to institutional investors that are at least "accredited investors" as defined in Regulation D of the 1933 Act (generally, an individual person with a net worth of $1 million or an annual income in excess of $200,000). This rule helped to better coordinate the CEA exemptions with those available under 3(c)(7) of the Investment Company Act of 1940 and the 1933 Act. There is a corresponding CFTC exemption for CTAs that advise pools exempt under Rule 4.13(a)(4).

Rule 4.13(a)(3)(De Minimis Exemption): The CFTC adopted this registration exemption for fund managers that engage in limited ("de minimis") commodity interest trading. The exemption provides for a CPO registration exemption for fund managers that: (i) engage in only a "de minimis" amount of futures trading, under one of two alternative quantitative constraints, and (ii) sell only to "accredited investors." This exemption helps to alleviate the burden of registration on hedge fund managers who use futures or options on futures only for hedging or in other very limited ways that are incidental to their securities trading.

Rule 4.5: This rule broadens the scope of the exclusion from the definition of CPO available to otherwise regulated "Qualifying Entities" (i.e., mutual funds, pension plans, insurance company separate accounts, bank trusts funds and similar otherwise regulated institutions) by eliminating the requirement that Qualifying Entities limit their commodity interest positions to a certain percentage of their overall portfolio.

MFA believes that the exemptions discussed above represent crucial relief for Commission registrants and have led to greater use of financial and commodity futures products in the financial marketplace. Prior to their adoption, many private pooled investment vehicles avoided using commodity futures and options in their trading because of the associated CPO registration requirement. The elimination of this requirement for certain funds has encouraged the growth of the futures industry as a result. We commend the CFTC for its efforts in implementing these exemptions, which we believe were important modernizations undertaken in accordance with the principles of the CFMA.

Notional Funds

With respect to performance data of notionally funded accounts, MFA supported the CFTC's decision to permit CTAs to use nominal account size as the basis for computing a client's rate of return rather than actual funds under a CTA's control. This 2003 amendment provides a uniform basis for all CTAs to present rate-of-return and allows for a more meaningful comparison of CTAs' performance results.

Bunched Orders

Also in 2003, MFA successfully worked with the CFTC and other relevant parties to adopt a fair and effective bunched order allocation structure for a broader class of account managers and customers of bunched accounts. By allowing all customers the opportunity to have their orders bunched, customers may receive better execution and better pricing of their orders.

Speculative Limits

Speculative position limits for futures contracts on various agricultural commodities has been an issue discussed at the CFTC for many years. Most recently, the CFTC requested comments on the Chicago Board of Trade's (CBOT) proposals for either the repeal or expansion of federal speculative limits applicable to certain agricultural futures and option markets under Commission Regulation 150.2.

MFA and its Members support the liberalization of federal speculative limits, and therefore urge this Subcommittee to support the CFTC in moving forward on this issue. Core Principle 5 of Section 5(d) of the CEA, applicable to designate contract markets, deals with Position Limitations or Accountability, and states that:

> To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary or appropriate.

Although the Commission retains the authority to set speculative position limits pursuant to Section 4a(a) of the CEA, the most recent pronouncement of Congressional intent, as set forth in the CFMA's Core Principles, squarely places responsibility for establishing position limits upon the exchanges. Therefore, we believe adoption of this proposal is consistent with the spirit and flexibility embodied in the CFMA, and will ultimately give futures exchanges the necessary tools to respond quickly to market conditions through speculative position limit adjustments.

Conclusion

MFA supports Congressional review and evaluation of the CFTC and the regulatory framework governing the U.S. futures markets. We believe it is beneficial to periodically examine federal agencies to determine whether their operations are meeting current policy objectives. At this time, MFA is not advocating any change to the

Commodity Exchange Act or the CFTC's existing authority thereunder. We believe that the progress that was made since the 2000 reauthorization has permitted the alternative investment industry to continue its astounding growth as a vital component of the global financial marketplace. If Congress does elect to consider making any modifications, including changes to the CFTC's enforcement authority in light of the *Zelener* case, we hope that it will be mindful of preserving the ideals of the CFMA and the progress made through its adoption in modernizing the legal and regulatory framework under which the agency and our U.S. futures markets operate.

MFA hopes that the Commission will continue to implement the CFMA's goals by undertaking to harmonize the SEC and CFTC rules governing hedge funds and public commodity pools and by liberalizing federal speculative limits. Overall, MFA believes that the Commission has demonstrated its willingness to solicit and actively consider suggestions and proposals by industry participants that will lead to greater modernization, efficiency and innovation in the futures industry. I look forward to answering any questions you might have.